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Nos. 00-511, 00-555, 00-587, 00-590 and 00-602

In the Supreme Court of the United States

VERIZON COMMUNICATIONS INC., *ET AL.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND
THE UNITED STATES OF AMERICA,
Respondents.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF RESPONDENT NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES

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QUESTIONS PRESENTED FOR REVIEW

Whether a utility can claim an unlawful confiscation under the Takings Clause where it has failed to demonstrate that the challenged rate decision has resulted in substantial harm to the financial integrity of the company.

Whether a utility can claim an unlawful confiscation by attacking the methodology employed in setting its rates absent a showing that the end result of the challenged order will have a significant adverse impact on its financial condition.

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The Order of the Federal Communications Commission which is the subject of this appeal is reported at *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 F.C.C.R. 15499 (1996).

STATEMENT OF JURISDICTION

This Court has jurisdiction of this matter under 28 U.S.C. § 1254(1).

CONSTITUTIONAL PROVISION AND STATUTES INVOLVED

This matter involves the Takings Clause of the Fifth Amendment to the United States Constitution, U.S. Const. amend. V; and the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56. The Telecommunications Act of 1996 amends the Communications Act of 1934, 47 U.S.C. § 151, *et seq*.

STATEMENT OF THE CASE

The instant matter comes to this Court on a challenge by Verizon Communications, Inc. ("Verizon") and other telecommunications companies of the decision of the Eighth Circuit Court of Appeals in the matter of *Iowa Utilities Board, et al. v. Federal Communications Commission and the United States of America*, 219 F.3d 744 (8th Cir. 2000)("*Iowa III*"). The *Iowa III* case dealt with challenges mounted by a number of parties to an Order by the Federal Communications Commission ("FCC") in its efforts to implement the local telephone competition provisions of the Telecommunications Act of 1996 ("Telecom Act").

The Telecom Act fundamentally changes telecommunications from a regulatory regime in which government encouraged monopolies, to a new regulatory regime where the barriers that protected monopolies from competition are removed, competition is affirmatively promoted, and new measures are created to support the provision of universal service. *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report & Order, 11 F.C.C.R. 15499 ("*Local Competition Order*"). As the FCC recognized in its *Local Competition Order*, historically, regulation of the telecommunications industry has been premised on the belief that service could be provided at the lowest cost to the maximum number of consumers through a regulated monopoly network. *Id.* at 15505. State and federal regulators devoted their efforts over many decades to regulating prices and practices of these monopolies and protecting them against competitive entry. The Telecom Act, however, adopts a different approach by requiring telephone companies to open their networks to competition. *Id.*

Sections 251 and 252 of the Telecom Act provide the specifics for how competition for the provision of local telephone service is to develop. In Section 251, Congress created the obligation for incumbent local exchange carriers ("ILECs") to allow their competitors, competitive local exchange carriers ("CLECs"), to interconnect with their network so that they may use those facilities to provide competing local telephone service. *See*, 47 U.S.C. § 251. Section 251 requires ILECs to provide such interconnection that is at least equal in quality to that provided by the ILEC to itself or to any subsidiary, affiliate, or any other party to which the carrier provides interconnection at rates, terms and conditions that are just, reasonable and nondiscriminatory. 47 U.S.C. § 251(c)(2). Congress also requires ILECs to provide such access to individual network elements on an unbundled basis, called UNEs (unbundled network elements), at rates, terms and conditions that are just, reasonable and nondiscriminatory so that a CLEC can combine such UNEs in order to provide a competing telecommunications service. 47 U.S.C. § 251(c)(3).

In Section 252, Congress articulated the procedures for negotiating, arbitrating and approving the interconnection agreements as well as the rates for UNEs. In particular, Section 252 provides that the rates for interconnection of facilities and UNEs as provided for in Section 251 shall be just and reasonable and based on the cost (determined without reference to a rate of return or other rate-based proceeding) of providing the interconnection or network element. 47 U.S.C. § 252(d)(1). This section also provides that the rates shall be nondiscriminatory and may include a reasonable profit.

The FCC, in issuing the *Local Competition Order*, adopted initial rules designed to implement Sections 251 and 252 of the Telecom Act and accomplish the goal of opening the local exchange and exchange access markets to competition. *Local Competition*

Order at 15507. Of particular relevance, the FCC's *Local Competition Order* established rules setting forth the pricing methods for states to use in setting prices if the ILEC and CLEC could not reach their own agreement. *Id.* at 15812. More specifically, the FCC established a forward-looking cost methodology known as Total Element Long Run Incremental Cost ("TELRIC") that sets prices of interconnection and access to UNEs based on forward-looking, economic costs that best replicate, to the extent possible, the conditions of a competitive market. *Id.* at 15846.

In this matter, Verizon bases its attack on the constitutionality of the FCC's Order, *inter alia*, on the premise that TELRIC allegedly will not allow the company to recover all the costs it believes it has incurred in the fulfillment of its interconnection obligations. Verizon Brief at 28. Verizon argues that the FCC's TELRIC rules have devalued the existing network and thus undercompensate carriers for the network elements they are compelled to provide to competitors under the Telecom Act. *Id.*

This is the second time an issue arising from the FCC's implementation of the *Local Competition Order* has been heard by this Court. In *AT&T Corp v. Iowa Utils. Bd.*, 525 U.S. 366 (1999) ("*Iowa II*"), this Court affirmed in part, reversed in part, and remanded the Eighth Circuit's original decision, *Iowa Utils. Bd. v. F.C.C.*, 120 F.3d 753 (8th Cir. 1997) *("Iowa I")*, regarding the FCC's rules established in the *Local Competition Order*. *See, Iowa III.* At that time, this Court, *inter alia*, reversed the portion of the Eighth Circuit's opinion pertaining to jurisdiction and held that the FCC had jurisdiction to design a pricing methodology. *Id.* at 748. On remand, the Eighth Circuit reviewed the merits of the FCC's forward-looking pricing methodology, proxy prices and wholesale

pricing provisions. *Id.* That review of the merits of TELRIC is now before this Court on appeal by Verizon.

The National Association of State Utility Consumer Advocates ("NASUCA"),[1] a party to the proceedings below, submits this Brief in opposition to Verizon. In particular, NASUCA urges this Honorable Court to reject the suggestion that the Orders below are in any way confiscatory or in violation of the Takings Clause of the Fifth Amendment to the United States Constitution.

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[1] NASUCA is an association of 42 consumer advocate offices in 39 states and the District of Columbia and includes members designated by the laws of their respective states to represent the interests of utility consumers before state and federal regulators and in the courts.

SUMMARY OF THE ARGUMENT

For more than half a century, this Court has consistently adhered to the principle that a utility cannot claim an unconstitutional confiscation of property in the ratemaking context unless it can first show that the complained of regulatory action has resulted in real financial harm to the company.[2] In reviewing an order that affects the rates of a utility, the Court has held that, "it is the result reached not the method employed which is controlling," and that "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry is at an end." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) ("*Hope*"). This Court reiterated this basic lesson of *Hope* in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989) ("*Duquense*"), where it stated that, "Today we reaffirm these teachings of *Hope Natural Gas*: '[I]t is not theory but the impact of the rate order which counts.'" *Duquesne* at 310.

Verizon's appeal directly challenges and urges this Court to overturn more than fifty years of constitutional law in the utility ratemaking context. Verizon challenges the TELRIC methodology without any effort to show that the total effect is unjust or that the Order will produce a substantial negative financial impact. Verizon thus fails to meet the threshold test for showing that the Order was confiscatory in violation of the Fifth Amendment.

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[2] While Petitioner Verizon addresses a number of issues in this appeal, NASUCA deals solely in its Brief with Petitioner Verizon's Fifth Amendment confiscation arguments.

ARGUMENT

I. Supreme Court Precedent Establishes the Principle That Utilities Do Not Have a Constitutionally Guaranteed Right to Recover Any Specific Type or Item of Cost.

A. Introduction

In its Brief in this matter, Petitioner Verizon argues that the requirement that rates be "just and reasonable" through Section 252(d)(1) of the Telecom Act incorporates the Fifth Amendment's assurance of just compensation. Verizon Brief at 24. While this principle is correct in the abstract, Verizon vastly overstates the impact of that principle in this case by suggesting that it has a constitutional right to recover every element of its historically incurred costs. As noted below, this has not been the law of the land since at least 1944.

This Court's precedent establishes the principle that utilities do not have a constitutionally guaranteed right to recover any specific type or item of cost. More than fifty years ago, this Court established the principle that a utility cannot claim an unconstitutional confiscation unless the overall rates set for that utility result in substantial harm to the financial integrity of the company. In the landmark decision in *Hope*, this Court ruled that, "it is the result reached not the method employed which is controlling" and that "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry... is at an end." 320 U.S. at 602. The underlying principle of *Hope* is that a utility does not have a constitutional right to recover costs associated with specific items of investment. Rather, it is the overall impact of the rates established for that utility that control whether a utility may claim an unconstitutional taking. *Id.*

The *Hope* decision was expressly affirmed by this Court in 1989 in rejecting the challenge of two Pennsylvania electric utilities that claimed a constitutional right to recover the costs for four cancelled nuclear power plants. In *Duquesne*, this Court stated that, "Today we reaffirm these teachings of *Hope Natural Gas*: '[I]t is not theory but the impact of the rate order which counts.'" *Duquesne* at 310. Verizon's suggestion that its confiscation claim in this case is somehow supported or compelled by this Court's decision in *Duquesne*, Verizon Brief at 17, 27, 34, is utterly without merit.[3]

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[3] Verizon's prayer that this Court adjudicate the company's constitutional claim is particularly inappropriate in light of this Court's long standing practice to avoid deciding hypothetical questions:

> This Court is without power to give advisory opinions. It has long been its practice not to decide abstract, hypothetical or contingent questions, or to decide any constitutional question *in advance* of the necessity for its decision, or to formulate a rule of constitutional law broader than is required by the precise facts to which it is to be applied.

Alabama State Federation of Labor, Local Union No. 103, United Brotherhood of Carpenters and Joiners of America, et al. v. McAdory, 325 U.S. 450, 461 (1945) (emphasis added, citations omitted). Until the actual rates can be reviewed, Verizon's takings claim is not ripe for consideration as the Eighth Circuit found. *Iowa III* at 754. NASUCA will discuss the lack of ripeness in a later section of this argument.

B. Supreme Court Precedent Dictates That Verizon's Takings Claim Here Must Fail.

1. The Supreme Court Has Repeatedly and Consistently Held That, in Determining Whether a Rate Order Can Be Challenged as Confiscatory, It Is the Overall End Result Reached, Not the Method Employed, That Is Controlling.

In the landmark decision of *FPC v. Hope Natural Gas, supra*, the United States Supreme Court ended decades of constitutional review of minute ratemaking details when it declared that, for purposes of its review, "it is the *result reached* not the method employed which is controlling," and that "[i]f the *total effect of the rate order* cannot be said to be unreasonable, judicial inquiry ... is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." *Hope* at 602 (emphasis added). *Hope* thus marked the end of an era of judicial intervention in utility ratemaking decisions during which the courts had ruled that, as a matter of constitutional right, the "fair value" of the property on which a utility's rates were set had to include some measure of the present value or reproduction cost, rather than be based upon the original or historical cost of the property. *Id.* at 599-600.

NASUCA submits that the *Hope* decision essentially established a two-part test to examine utility confiscation claims arising from a rate order. First, the Court will determine whether the end result of the rate order produces substantial harm to the investor interest. If the rate allowance permits the utility to operate successfully and to attract capital, the utility cannot claim confiscation, and the constitutional review of the rate order is at an end. Second,

if the rate order results in substantial harm to investors, the Court will then examine whether such harm is justified by countervailing public policy or consumer interests. In *Hope*, the Court did not reach the second part of the test because it found that the end result did not substantially harm investor interests. *Id.* at 603.

The scope of the *Hope* decision was perhaps most thoroughly discussed in a 1987 decision of the District of Columbia Circuit Court of Appeals. In the *en banc* decision in *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987), three separate opinions emerged, discussing which rule to use to determine a regulatory taking under *Hope*. Judge Bork, writing for the majority, said it was necessary to consider all "prudent investment"; the dissenting opinion authored by Judge Mikva advocated the application of the "used and useful" rule; and Judge Starr, while voting with the majority, suggested that it was appropriate to consider a combination of both measures to arrive at a balanced determination. *Jersey Central* at 1169, 1188, 1194.

Most important here, however, despite this disagreement regarding how much of the utility's property to consider in deciding a takings claim under *Hope*, there was no dispute in the *Jersey Central* case that, under this Court's precedents, there can be no finding of a taking without a showing of substantial financial harm to the utility. As the majority opinion explained:

> Under *Hope*, as we have stated repeatedly, the only circumstance under which there is a *possibility* of a taking of investors' property by virtue of rate regulation is when a utility is in the sort of financial difficulty described in Justice Douglas' opinion. ..... But absent the sort of *deep financial hardship* described in *Hope*, there is no taking, and hence no

> obligation to compensate, just because a prudent investment has failed and produced no return.

Jersey Central at 1181 n.3 (emphasis added). Under the present record in the appeal to this Court, Verizon has not alleged -- nor could the company demonstrate -- the requisite "deep financial hardship" described above.

The United States Supreme Court has clearly found no constitutional flaw in the fact that certain rates might not permit some utilities to recover a return of and a return on all of their investments. In *In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), the Court held that there was "no constitutional infirmity" in the adoption of an area rate system for certain gas producers. *Id.* at 774. The Court upheld, as a matter of administrative necessity, a ratesetting procedure that was based on the *average* costs of a large number of natural gas producers and did not specifically address the investor interests in the capital costs of individual producers. The Court noted that, while the investor interests set forth in *Hope* remain "pertinent," they "scarcely exhaust the relevant considerations." *Permian Basin* at 791.

Any doubt that it is the result reached, not the method employed, that is of constitutional significance was eliminated by the Supreme Court's decision in *Duquesne*. In that case, two Pennsylvania electric utilities were denied *any recovery whatsoever* for costs that were incurred on four cancelled nuclear power plants. This Court decided that utilities could not claim an unlawful taking even if they received *zero recovery* of certain specific cost items unless they could show that the *overall* rate levels were not just and reasonable. The Court held that a "scheme of utility regulation does not 'take' property simply because it disallows recovery of capital investments that are not 'used and useful in service to the public,'"

even where it excludes costs that were prudent and reasonable when made. *Id.* at 301-02. In so doing, the Court reemphasized, "Today we reaffirm these teachings of *Hope*: '[I]t is not theory but the impact of the rate order which counts.'" *Id.* at 310.

2. The Supreme Court Has Rejected Arguments That Utilities Such as Verizon Have a Constitutional Right to Recover Every Dollar They Invest in Providing Utility Service, Even Where Those Investments Were Found to Have Been Prudently Made.

Verizon argues that the FCC applied the wrong standard of "financial integrity" that "limited its inquiry to revenues for which it was responsible and instead sought to conscript all of an incumbent's revenues to cure the obvious inadequacy of TELRIC rates." Verizon Brief at 36. Verizon argues that this standard is impermissible and that the FCC erred in failing to conduct the inquiry allegedly demanded by *Duquesne* to see whether the TELRIC rates for UNEs will preserve the ILECs opportunity to recover their past prudent investments.

Prior to *Hope*, this Court and other appellate courts engaged in the very type of constitutional judicial scrutiny that Verizon is calling on this Court to perform here. In many of those early cases, the utilities argued that they had a constitutional right to recover reproduction costs (or fair value), which were ostensibly higher than original or embedded costs. The Court in *Hope* upheld the use of original cost by the Federal Power Commission, but more importantly concluded that it is the end result reached, not the methodology employed, that is controlling. In the present matter, by focusing on certain embedded costs and the purported infirmities of

the FCC's forward-looking treatment of costs, Verizon demonstrates its misconception that utility investors have a constitutionally guaranteed interest in the recovery of specific items of cost or investment, rather than the overall justness and reasonableness of their rates.

Indeed, decisions from this Court after *Hope* confirmed that there are instances in which less might be allowed than is necessary to satisfy even the overall investor interests described in *Hope*. For example, just one year after *Hope*, the Court unanimously ruled in *Market Street Railway Co. v. Railroad Commission*, 324 U.S. 548 (1945), that the rates set for a failing street railway company were not confiscatory. In response to the company's claim that the rate order was confiscatory under *Hope* because it did not insure the financial integrity of the enterprise, the Court responded:

> It was noted in the *Hope Natural Gas* case that regulation does not assure that the regulated business make a profit. 320 U.S. at 603; *see, Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590. All that was held was that a company could not complain if the return which was allowed made it possible for the company to operate successfully.

Market Street Railway at 566.

In the present case, Verizon insists that, "the FCC's duty – both under [Takings] principles and the express directive of Section 252 – was to set UNE rates that would allow the UNE business to generate a sufficient return to stand on its own." Verizon Brief at 35. Whatever Verizon means by "UNE business" "standing on its own," it is clear that the Constitution does not guarantee that a utility will

recover every dollar of investment on any particular service. Nor does the Constitution guarantee that the utility will make a profit on every investment.

In *Duquesne*, the Court summarily rejected the suggestion that utilities are constitutionally entitled to a return of and on all prudent investment. The Court stated that selection of a single prudent investment standard would "signal a retreat from 45 years of decisional law." *Id.* at 315.[4] Furthermore, the Court stated that "an otherwise reasonable rate is not subject to constitutional attack by questioning the theoretical consistency of the method that produced it." *Id.* at 314. In the instant appeal, it is the FCC methodology that Verizon attacks, without any demonstration that the end result is unjust and unreasonable.

To suggest, as Verizon does, that *Duquesne* stands for the proposition that utilities have a constitutional right to recover all of their costs is simply wrong. With respect to the specific investments at issue in *Duquesne*, the utilities did not recover their historical cost; they did not recover their incremental cost; they did not recover anything. In *Duquesne*, this Court upheld its long-standing constitutional standard and decided that, unless the overall end result was unjust and unreasonable, the utilities had no constitutional claim.

Furthermore, when the Court has been faced with the question of whether an unconstitutional confiscation has occurred in the ratemaking context, it has examined the overall rates, not each specific item comprising those rates. This is consistent with the

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[4] The Court noted that such a standard would be particularly inappropriate in light of the emergent competitive wholesale market for electric generation. *Id.* at 316 n.10.

Court's general "takings" jurisprudence where the Court has compared the value of the property allegedly taken to the value of the entire property at issue. As the Court explained in *Keystone Bituminous Coal Association v. DeBenedictis*, 480 U.S. 470 (1987):

> Because our test for regulatory taking requires us to compare the value that has been taken from the property with the value that remains in the property, one of the critical questions is determining how to define the unit of property 'whose value is to furnish the denominator of the fraction.'

Id. at 497. Thus, the Court must consider the "numerator" and the "denominator" in the financial equation to define the extent of the harm suffered by the utility as a result of the regulatory action under review.

3. The Circuit Courts Have Correctly Recognized That TELRIC Cannot Be Found Unconstitutional On Its Face.

According to Verizon, it is the "objective of a utility ratemaking regime to avoid future government liability for an uncompensated taking by requiring the regulator to design rates that will fully compensate the utility." Verizon Brief at 24. Verizon then argues that applicable legal principles require recovery of every dollar invested in its utility operations. *Id.* at 25. In the instant case, Verizon has failed to meet the threshold requirements prescribed by *Hope* to establish an unconstitutional confiscation. Rather, Verizon has produced only a few isolated instances where TELRIC may produce rates that are lower than historical costs. *Id.* at 10, 14.

The Eighth Circuit noted below that the rates for UNEs were to be set by state commissions and, therefore, were largely yet unknown. *Iowa III* at 754. Verizon has not provided any comprehensive data concerning the impact of the FCC's Order on the financial aspects of its operations. Verizon has not provided any evidence tending to show that the Company has suffered a substantial negative impact as a result of the FCC's Order. Instead, Verizon complains that the FCC failed because it did not explicitly preserve the ability of incumbents to recover all costs they have incurred in building the present network. Verizon Brief at 25. This is not the constitutional standard set forth in *Hope*.

In rejecting Verizon's Takings argument, after reviewing all of the Verizon data presented, the Eighth Circuit below held that:

> The Constitution protects public utilities from rates which are "so unjust as to be confiscatory." However, a takings claim cannot be based on the ratemaking methodology, but rather it must be based on the rate itself. "It is not theory but the impact of the rate order which counts." Until the actual rates are established we cannot conclude whether the impact of TELRIC driven rates will constitute a taking. "It is not enough that a party merely speculates that a government action will cause harm."... The possibility that a regulatory program may result in a taking does not justify the use of a narrowing construction. In such circumstances, the adoption of a narrowing construction might frustrate a potentially permissible application of a statute. Because the consequences of the FCC's choice to use TELRIC methodology cannot be known until the

> resulting rates have been determined and applied, the constitutional claim is not ripe.

Iowa III at 754 (citations omitted).

The Fifth Circuit has also addressed the issue of whether a takings has occurred in the context of the FCC using TELRIC to establish universal service funding. In *Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999), *cert. dismissed*, 121 S.Ct. 423, 148 L.Ed.2d 327 (2000), GTE argued that TELRIC was unconstitutional because it left ILECs exposed to competition without first implementing a new universal plan that results in a reduction of its revenues from local service. *Id.* at 437. The Fifth Circuit held that GTE's takings claim "has no merit because it has not shown that a taking has occurred or that any taking will be permanent or would be so serious as to be considered 'confiscatory.'" *Id.* at 413, fn. 14. The Fifth Circuit also held that "even if GTE can show that some taking will result, it must demonstrate that its losses are so significant that the 'net effect' is confiscatory." *Id.* at 437. The Fifth Circuit held that:

> GTE has failed to meet the requirements of *Duquesne* because it cannot show that it will lose any revenue at all, much less enough to constitute a taking under more recent precedent. ... *Duquesne* does not require courts to engage in a takings analysis whenever an agency opens a previously regulated market to competition.

Id.

4. Verizon's Reliance on the Brooks-Scanlon Case is Misguided.

Verizon argues that, where a regulator controls revenues in only a segment of a firm's overall business, the regulator may only look at that specific enterprise in determining whether the overall end result of its Order is just and reasonable. Verizon cites this Court's decision in *Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396 (1920), to support that position. Verizon further argues that the FCC's duty under Section 252 was to set UNE rates that would allow the UNE business to generate a sufficient return to stand on its own and ensure that UNE rates fully cover the costs of that business. *Id.* at 35.

Verizon's reliance upon *Brooks-Scanlon* is unfounded. In *Brooks-Scanlon*, a sawmill had developed a railroad as a subsidiary business in order to bring logs to the sawmill. *Brooks-Scanlon* at 398. After all of the timber had been cut, the railroad operated at a loss, but Brooks-Scanlon was denied permission by the Louisiana Railroad Commission to terminate its railroad operation. The United States Supreme Court reversed that decision. In that case, the Supreme Court held that where a railroad serving the public is owned and operated by a lumber company, it is the business of the railroad, and not the profits from the lumber company, that determined whether the railroad may abandon regulated service as unprofitable.

The applicability of *Brooks-Scanlon* to the issues in the present case, however, is called into question by subsequent decisions of this Court. In *Broad River Power Co. v. South Carolina*, 281 U.S. 537 (1930), the Supreme Court explained that its holding in *Brooks-Scanlon* was made on the basis that "the private business, the lumber company, was not devoted to a public use or a part of the public franchise." *Id.* at 544. In the *Broad River*

case, the Court considered the overall business of a profitable electric company and its unprofitable subsidiary railway, both of which were devoted to a public use. Similarly, in *Baltimore & O.R. Co. v. United States*, 345 U.S. 146 (1953), when a railroad complained that its rates for carrying certain kinds of vegetables were confiscatory, the Court responded that, "So long as a railroad is not caused by such regulation to lose money on its overall business, it is hard to think that it could successfully charge that its property was being taken for public use 'without just compensation.'" *Id.* at 148.

A critical fact in *Brooks-Scanlon* was that the utility owner wished to withdraw entirely from offering any public utility service. The Court agreed that it should be permitted to exit the railroad business, but explained that, if a public utility wished to continue to operate under its regulatory charter, then a regulatory commission "may require it to fulfill an obligation imposed by the charter even though fulfillment in that particular may cause a loss." *Brooks-Scanlon* at 399 (citing *Missouri Pacific Ry. Co. v. Kansas*, 216 U.S. 262, 276, 278 (1910)). Verizon certainly has not suggested that it wishes to abandon its vast telecommunications network. Nor has Verizon suggested that the FCC is forcing it to operate its telecommunications network at a loss. The *Brooks-Scanlon* case does not support Verizon's position in this case.

Clearly, Verizon's operations are much more diverse than the Brooks-Scanlon Company's operations were. Verizon has many segments of its business from which it draws revenues and it is unclear which segment or segments, and the accompanying revenues, Verizon believes should be excluded in the total effect test. *See*, Verizon Brief at 33. Verizon cites *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930), for the proposition that a regulator may not justify deficient rates by pointing to revenues from operations under

a different sovereign's jurisdiction. NASUCA submits that Verizon provides many services over the same physical plant and that all revenues from such services should be considered in the overall end result test.

C. Verizon Has Not Demonstrated Here That A Takings Has Occurred.

1. Verizon Has No Factual Basis Upon Which to Demonstrate an Unconstitutional Taking Because the Overall Impact of the FCC Pricing Methodology on the Company's Financial Integrity Is Not Yet Known.

Because *Hope* and its progeny establish that the courts must consider the *end result* of the regulation, it becomes apparent that the record in this matter is simply not sufficient to support the sweeping claims of confiscation made by Verizon. The Court thus lacks the factual predicate upon which to make such a determination. In fact, the Eighth Circuit, in *Iowa III* below, found that it was unsure how TELRIC would affect state rates for interconnection and UNEs. The Eighth Circuit held that, "until the actual rates [under TELRIC] are established, we cannot conclude whether the impact of TELRIC driven rates will constitute a taking" and that "because the consequences of the FCC's choice to use TELRIC methodology cannot be known until the resulting rates have been determined and applied, the constitutional claim is not ripe." *Iowa III* at 754.

Under traditional "takings" jurisprudence, the Court must engage in "essentially *ad hoc*, factual inquiries" that address such factors as 1) the economic impact of the regulation; 2) the nature of the government action; and 3) the extent to which the regulation has

interfered with investor-backed expectations. *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978). At the present time, Verizon and the other incumbents have presented this Court with little more than a competing alternative theory to the FCC's pricing methodology, virtually devoid of the essential facts regarding economic impact or interference with investor-backed expectations by which this Court could conclude that the FCC's pricing methodology, once applied, would effect a taking. Verizon's assertion of harm is based on a few isolated instances where TELRIC may produce rates lower than historical costs. Verizon Brief at 10, 14. Otherwise, Verizon's assertion is conditioned upon factors in the future and is wholly speculative.

In the instant matter, Verizon has not sufficiently specified the value of the property allegedly taken, and it has failed to set forth the value of the entire property at issue. Because of the absence of this critical information, Verizon cannot claim, much less prove, that the FCC's Order has caused substantial harm to its financial condition. Absent an allegation of a significant negative impact on its financial condition, Verizon cannot claim an unconstitutional confiscation. In particular, Verizon cannot satisfy the test set forth in *Keystone Bituminous Coal, supra*, based on the record before the Court.

There is absolutely no basis at this time for the Court to conclude that the application of the FCC pricing rules will have a confiscatory impact. "A court cannot determine whether a regulation has gone 'too far' unless it knows how far the regulation goes." *MacDonald, Sommer & Frates v. Yolo County*, 477 U.S. 340, 348 (1986). Further, an administrative agency is entitled to observe the actual result of the operation of its regulations for a reasonable period of time before a court could conclude that the agency's actions were arbitrary or capricious. *Tenoco Oil Co. v. Dept. of Consumer Affairs*, 876 F.2d 1013, 1028 (1st Cir. 1989). In

Tenoco Oil, the First Circuit held that a takings clause challenge to gasoline pricing restrictions was not ripe for constitutional review, in large measure because the record was not adequately developed, and the agency had expressed a willingness to adjust its price order upon receipt of subsequent evidence. *Tenoco Oil* at 1026. The Court emphasized that until the wholesalers had requested and been refused relief pursuant to procedures set forth in the agency's order, a federal court could not yet know whether the agency's regulations confiscate property. *Id.*

Indeed, the FCC itself has recognized the evolving and fact-specific nature of its *Local Competition Order*:

> Incumbent LECs may seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates. We also do not completely foreclose the possibility that incumbent LECs will be afforded an opportunity to recover, to some extent, their embedded costs through a mechanism separate from rates for interconnection and unbundled network elements. As stated above, we intend to explore this issue in detail in our upcoming access reform proceeding.

Local Competition Order, 11 F.C.C.R. at 15872, ¶ 739.

Although the Fifth Amendment protects utilities from regulatory actions that are so unjust as to be confiscatory, "[i]t is not enough that a party merely *speculates* that a government action will cause it harm." *Alenco Communications, Inc., et al. v. FCC*, 201 F.3d 608, 624 (5th Cir. 2000) (emphasis added). In *Alenco*, a large

number of rural local telephone companies challenged two FCC Orders promulgated to make changes to universal service consistent with the Telecom Act. The telephone companies in *Alenco* made takings claims similar to those raised by Verizon in its brief in this matter, and the Fifth Circuit Court flatly rejected those claims. The Court found that the phone companies in *Alenco* had failed to show a taking because they relied on mere speculation to support their Fifth Amendment arguments. The *Alenco* Court explained that:

> petitioners must wait to experience the actual consequences of the Order before a court may even begin to consider whether the FCC has effected a constitutional taking. Until it is known what level of universal service funding each petitioner will receive under the Order, and under what circumstances the Commission will grant a waiver, we cannot seriously entertain a Takings Clause challenge.

Alenco at 624.

In the instant matter, Verizon is in the same position as the *Alenco* petitioners. Verizon cannot be said to have made a sufficient showing of a taking because none of the deprivations of company property claimed by Verizon has occurred. In fact, there is no evidence that Verizon has experienced any financial harm due to the FCC's Order, and even if such an adverse effect would ever materialize, it might not amount to an unconstitutional taking under the Fifth Amendment to the U.S. Constitution.

2. Actual Results Do Not Show That the FCC Pricing Methodology Has Had a Substantial Negative Impact on Verizon's Financial Integrity.

Presently, there is no indication that the FCC's pricing rules have resulted in the type of deep financial hardship necessary to show an unconstitutional taking. In fact, there is publicly reported data indicating that the FCC's TELRIC methodology has not resulted in financial losses for the incumbents. In the March 2000 edition of the Federal Communications Law Journal, economists David Gabel and David I. Rosenblum presented data that indicate that no taking has resulted from TELRIC pricing. Gabel & Rosenblum, *Who's Taking Whom: Some Comments and Evidence on the Constitutionality of TELRIC*, 52 Fed. Com. L.J. 239 (March 2000). Following a review of financial information submitted to the FCC by 150 of the largest telephone companies in the country, Messrs. Gabel and Rosenblum concluded that:

> Given the rates of return on regulated investment, and the rates of return on embedded investment, it seems clear that the majority of telephone companies in the survey are earning returns that are more than sufficient to assure confidence in the financial integrity of their enterprises, maintain credit worthiness and to enable them to attract additional capital. Based on this data it would seem that the ILECs and their supporters' contention, that the use of the TELRIC methodology, on its face, results in a taking, is not grounded in the reality depicted by their earnings reports.

52 Fed. Com. L.J. at 265 (footnote omitted).

Publicly available FCC reports also suggest that Verizon continues to realize substantial earnings from its investments. Financial reports from the FCC demonstrate in 1999 that Verizon and other regional Bell operating companies and the former GTE realized net income of $11.8 billion on stockholder's equity of $60.8 billion.[5] Verizon certainly has not demonstrated that the FCC has forced it to operate at a loss, or indeed anything less than a very substantial level of profit. There is no basis at this time to conclude that the FCC has not fully satisfied the investor interest under the standards announced in *Hope*. *Hope* at 603.

3. Verizon Has Failed To Account For Its Revenues From Many Sources In Its Constitutional Takings Claim.

NASUCA has explained above the many reasons why Verizon has failed to present a constitutional claim that the Court should recognize. Even if the Court finds that Verizon has presented a constitutional claim that the court should review, Verizon has failed to acknowledge the many sources of revenues that must be considered in reviewing such a takings claim.

The crux of Verizon's argument appears to be that "TELRIC violates the Just Compensation Clause because it represents a fundamental shift in methodology that makes no provision for the recovery of prior prudent investment, but rather is designed to preclude such recovery." Verizon Brief at 17. Verizon asks this

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[5] FCC Statistics of Communications Common Carriers for 1999, pages 57, 61 at Table 2.10 available online at http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/socc.html

Court to make a constitutional determination concerning an assumed shortfall of revenues below its costs without adequately explaining what revenues should be counted in comparison to costs and why certain revenues should be dismissed from the revenue/cost analysis. A fundamental problem with this argument is that Verizon has not even adequately explained what Verizon service revenues should be considered in comparison with Verizon's costs in any constitutional takings analysis.

Verizon has presented no authority by which it can contend that it is constitutionally entitled to recover specific costs of providing access to its network to competitors through interconnection or UNEs. Verizon still has an opportunity to recover its costs from the myriad of services that it sells to its customers, as well as from other funds.[6] Neither the Telecom Act nor the United States Constitution guarantee full cost recovery from only one category of service.

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[6] For example, GTE, Inc., which merged with Bell Atlantic to form Verizon, recovers revenues from state Universal Service Funds pursuant to 47 U.S.C. § 254(c) and (f), which must also be taken into account. Verizon has failed to offer any information concerning this source of revenue.

Verizon reported $15.2 billion of total revenue to the FCC in 1999. This includes $4.8 billion of "Basic Area Revenue" realized for local service or universal service. The remaining revenue is produced by optional vertical services, access revenues received from interexchange carriers, long distance revenues, telephone directory revenues, etc. FCC Statistics of Communications Common Carriers for 1999, page 58 at Table 2.10, available online at http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/socc.html

Verizon does not have a constitutional right to earn a profit on every telephone call it carries. Nor does it have a constitutional right to earn a profit from every customer it serves. Verizon also has no constitutional right to recover all of the costs of its multiple products and services network only through interconnection and UNE rates. NASUCA respectfully submits that this Court must view Verizon's constitutional takings claim in light of the many services that Verizon sells to consumers over similar facilities. Verizon's vast network is used in a joint and common fashion to produce a wide array of telephone services in addition to TELRIC based UNE services. Revenue to cost relationships will necessarily vary based upon the characteristics of the customers, the services they purchase and whether the services are offered in a retail or wholesale market. Verizon should not prevail on a theoretical takings claim based upon TELRIC pricing to a part of its markets.

NASUCA emphasizes that what ultimately matters under the test set forth in *Hope* "is whether that order 'viewed in its entirety'" presents a constitutional takings claim. *Hope* at 602. In order to examine Verizon's takings claim, this Court must consider the financial position of Verizon in light of the broad range of revenues that it receives related to its vast array of telecommunications operations. Any such consideration will lead to the conclusion that Verizon has not suffered the type of overall financial harm that is necessary to raise a constitutional takings claim.

II. The Supreme Court Has Rejected Challenges To Utility Rate Decisions On The Basis Of Objections To The Use Of A Particular Cost Recovery Methodology Or Specific Cost Allowances.

In its Brief in this matter, Petitioner Verizon argues that the FCC's implementation of TELRIC represents a fundamental shift in methodologies which "necessarily raises the question whether the new methodology is sufficient to provide a constitutionally adequate return with respect to investments made under the prior regime." Verizon Brief at 26. Verizon's request constitutes an attempt to have this Court reject 50 years of established takings doctrine in the context of utility regulation. Verizon asks this Court to declare the FCC's TELRIC methodology unconstitutional under the Fifth Amendment even though the Company has not even attempted to demonstrate that it has suffered substantial financial harm. Adopting Verizon's approach would immerse the Court in a constitutional examination of ratemaking theory for the telecommunications industry. This is exactly the sort of action the Court refused to take in *Hope* and its progeny. As stated above, this Court has repeatedly stated that, in deciding a takings claim, it will not look to the methodology employed in arriving at utility rates. Instead, this Court has stated that it will first examine the end result of the rate decision to determine whether a confiscation claim can even be made. *Hope* at 602; *Duquesne* at 310.

NASUCA submits that, establishing a new methodology for a new rate element, UNE rates, does not represent a taking. Rather, the FCC Order represented a necessary development in order to carry out its Congressional mandate to move toward the new competitive environment envisioned under the Telecom Act. In passing the Telecom Act, Congress created a new rate element which did not exist before, *i.e.*, the rate for a particular network

element if sold separately as well as the rate to connect into the existing network. Through the *Local Competition Order*, the FCC was creating rules which will establish rates for these new elements. As a matter of necessity, the FCC had to create a "new" methodology to establish rates for this new service. While Verizon might not agree with the FCC's policy determination in this respect, that disagreement cannot rise to a constitutional confiscation claim unless the overall end result of the FCC's action is unjust and unreasonable.

Verizon duly cites the leading United States Supreme Court and United States Courts of Appeals cases that address confiscation of property in a utility rate setting process. However, Verizon's presentation of the relevant precedent wholly misperceives the nature and effect of those rulings, even beyond the speculation inherent in the Company's claims of confiscation. Whatever Verizon may think of the economic merits of the TELRIC method adopted by the FCC, it is simply impossible, under applicable United States Supreme Court precedent and the facts presented, for Verizon to claim that the FCC's selection of this method, in and of itself, would accomplish an unconstitutional taking.

NASUCA respectfully submits that Verizon's assertions regarding this issue are clearly refuted by the plain language of the *Duquesne* opinion. There is no constitutional prohibition against a regulatory agency adopting a new method of setting utility rates. While the Court observed in *Duquesne* that "a State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions," *Duquesne* at 315, that is not what occurred in *Duquesne*, and that is not what occurred here. The Court in *Duquesne* recognized that, "circumstances may

favor the use of one ratemaking procedure over another." *Duquesne* at 316.

The present case does not deal with a situation where the FCC is switching back and forth between methodologies in a manner that is detrimental to the investor interest in every instance. The adoption of TELRIC by the FCC was an economic and policy judgment that the FCC made in order to implement the Congressional directive of the Telecom Act. While Verizon may disagree with the theoretical basis for that determination, it cannot be claimed to have effected an unconstitutional confiscation unless and until the end result of the methodology is shown to have caused substantial financial harm to the utility. There has been absolutely no such showing here.

In support of its argument, Verizon cites the concurrence by Justice Scalia in the *Duquesne* case in stating that for courts to determine whether a rate methodology provided a constitutionally adequate "fair return," "all prudently incurred investment may well have to be counted." Verizon Brief at 28, *quoting*, *Duquesne* at 317 (concurring opinion). The concurring opinion in *Duquesne*, however, is not supportive of Verizon's arguments in this case. In that concurring opinion, Justice Scalia, joined by Justices White and O'Connor, confirmed the basic principle of *Duquesne* that the consequence of regulation, not the technique used, is the critical consideration in determining whether a takings claim can be made. The issue addressed in the *Duquesne* concurrence was whether, for purposes of confiscation analysis, it is necessary to look at all of a utility's "prudent investment" or only the assets that were "used and useful" in serving the public. *Duquesne* at 317. As noted in Justice Scalia's concurring opinion, however, "as the Court's opinion describes, that question is not presented in the present suit which challenges techniques rather than consequences." *Id.*

Challenging techniques, of course, is precisely what Verizon has done in the present appeal. Specifically, it has challenged the "technique" of the FCC's adoption of the TELRIC methodology rather than the consequences. Thus, Verizon's argument fails just as clearly under the concurring opinion in *Duquesne* authored by Justice Scalia as it does under the Court's Opinion authored by Chief Justice Rehnquist.

Verizon has also argued that TELRIC has the effect of "rewriting the terms of thousands of regulatory transactions closed long ago." Verizon Brief at 30. NASUCA submits that this argument too should fail based on the Supreme Court precedent which holds that it is not the method, but the end result which determines whether a taking has occurred. *Supra*. Based on that precedent, Verizon cannot argue that any damage will have occurred to those allegedly "rewritten" transactions until the end result has been reached. NASUCA submits that such end result has not yet been reached.

III. Verizon's Takings Claim is Premature, Speculative and Not Ripe For Review.

A. Verizon Does Not Have a Legitimate Takings Claim Because the Total Effect of The Challenged Order is Not Yet Known.

As argued above, Verizon has failed to set forth the necessary facts to support its takings claim. As a result, its appeal is not ripe for review by this Court. In *FPC v. Texaco Inc.*, 417 U.S. 380 (1974), the Court rejected a facial attack on a proposed method for "indirect regulation" of small gas producers under the Natural Gas Act, and noted:

> Any broadside assertion that indirect regulation will be confiscatory is premature. The consequences of indirect regulation can only be viewed in the entirety of the rate of return allowed on investment, and this effect will be unknown until the Commission has applied its scheme in individual cases over a period of time.

Id. at 392.

This principle was also confirmed in *Mobil Oil Corp. v. FPC*, 417 U.S. 283 (1974), in which the Court rejected an attack against the area rates established for certain gas producers. In that case, the Court noted that the premise of the arguments -- that certain provisions of the order can be isolated and viewed without regard to the total effect of the order -- was in error. *Id.* at 315. The Court further rejected Mobil's argument that assumed that there was only one just and reasonable rate possible for each vintage of

gas, and that this rate must be based entirely on cost plus a reasonable rate of return. *Id.* at 316.

In *FERC v. Pennzoil Producing Co.*, 439 U.S. 508 (1979), the Court criticized the Court of Appeals in that case for attempting to limit the discretion of the Federal Energy Regulatory Commission (FERC) in setting rates under the Natural Gas Act. While agreeing that the FERC Order, which granted exceptions to area rate levels, had to be remanded, the Court also stated:

> We are also convinced, however, that the Court of Appeals trenched upon the ratemaking authority vested in the Commission when it strongly suggested that the Commission is required to grant the relief Producers request in this case so long as the increase in royalty costs is not imprudent and the relief, when granted, will merely sustain rather than increase Producers' profits.

Id. at 517. The Supreme Court thus flatly rejected the suggestion that a utility is entitled as a matter of constitutional law to recovery of all prudent costs.

These cases uniformly demonstrate the Court's reluctance to find a taking where there is a facial, broadside attack based not upon the end result, but rather upon the possible outcome of ratemaking methodologies not yet applied.

To the extent that Verizon suggests in its brief that it is not claiming an actual taking in this case, but rather is urging a limiting interpretation of the Telecom Act that would prevent such a taking, Verizon Brief at 37, that argument must fail as well. As stated by the D.C. Circuit Court of Appeals in *National Mining Association v.*

Babbitt, 172 F.3d 906 (D.C. Cir. 1999): "We will not 'frustrate[] permissible applications of a statute or regulation,' ... based on the specter -- rather implausible from what we can tell now -- of a future unconstitutional taking." *Id.* at 917 (quoting *United States v. Riverside Bayview Homes*, 474 U.S. 121, 127-28 (1985)).

Here, Verizon's speculative, theoretical claim does not justify a finding that a taking has occurred. Nor does it justify a finding that, absent some limiting ruling by this Court, the FCC Order and the interconnection provisions of the Telecom Act will somehow necessarily result in a future unconstitutional taking of Verizon's property.

B. The FCC Order Under Review Has Not Deprived Verizon of Any of its Property.

In its Order, the FCC fully considered and properly rejected Verizon's confiscation arguments. The FCC methodology is not solely theoretical. Nor did the FCC fail to fully articulate a reasonable basis for its decision.[7] After a voluminous and detailed examination of various considerations advanced by all parties, the FCC concluded that its forward-looking incremental cost standard "is consistent with the Fifth Amendment and is not confiscatory." *Local Competition Order*, 11 F.C.C.R. at 15855, ¶ 701. The

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[7] In this matter, the FCC's *Local Competition Order* reveals that the FCC clearly considered and rejected Verizon's position after substantial comment and input from a wide range of parties. *Local Competition Order*, 11 F.C.C.R. at 15842-3, 15869-72, ¶¶ 670-671, 733-740. Verizon and other incumbents argued that pricing based on TELRIC would result in an unconstitutional taking of the incumbent's invested capital but that argument was properly rejected.

FCC cited several cases relied upon by Verizon in its present appeal, notably *Hope Natural Gas*, *Permian Basin*, and *Duquesne*. After citing these cases, the FCC noted:

> Incumbent LECs argue that establishing a rate structure that does not permit recovery of historical or embedded costs is confiscatory. We disagree. As stated above, the Court has consistently held since *Hope Natural Gas* that it is the end result, not the method used to achieve that result, that is the issue to be addressed. Indeed, the Court has found that the "fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid." Moreover, the Court has upheld as reasonable changes in ratemaking methodology when the change resulted in the exclusion of historical costs prudently incurred. Thus, the mere fact an incumbent LEC may not be able to set rates that will allow it to recover a particular cost incurred in establishing its regulated network does not, in and of itself, result in confiscation.

Local Competition Order, 11 F.C.C.R. at 15870-71, ¶ 736 (footnote omitted).

The FCC properly concluded after a full review of the record in its Local Competition proceeding that, "[n]o incumbent LEC has provided persuasive evidence that prices based on forward-looking economic cost methodology would have a significant impact on its 'financial integrity.'" *Id.* at 15871, ¶ 738. In addition, the FCC correctly stated that the end result test considers the "overall

regulatory framework" and whether the incumbent LECs have a reasonable opportunity to recover a return on their investment in light of the revenues from "the incumbent LECs' overall rates.... including the revenues for other services under [the FCC's] jurisdiction." *Id.* at 15871, ¶ 737.[8]

Verizon has not experienced a taking that requires compensation and has not set forth here a claim that is ripe. Verizon has failed to demonstrate that a taking has, in fact, occurred.

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[8] The leasing of a local loop to a competitor under the interconnection and UNE provisions of the Telecom Act does not constitute a physical taking without just compensation by obliging the ILEC which owns the loop to lease them to a CLEC. *Qwest Corporation v. United States*, 48 Fed.Cl. 672, 692 (February 20, 2001).

CONCLUSION

For the reasons set forth above, NASUCA submits that the FCC Order here under review cannot be challenged as confiscatory. There has been no showing whatsoever that the Order violates the longstanding test established by the United States Supreme Court for determining whether confiscation has occurred in the ratemaking context. The argument by Verizon that the FCC's use of the TELRIC methodology is unconstitutional must be rejected.

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